Criteria | Financial Institutions | Banks:

Commercial Paper I: Banks

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(***Editor's Note:*** *This article has been superseded by "Financial Institutions Rating Methodology," published Dec. 9, 2021, except in jurisdictions that require local registration.)*

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Commercial paper is a money market instrument in the form of an unsecured promissory note issued by corporations and financial institutions to raise short-term funds. In the U.S., the tenor of commercial paper extends from overnight to a maximum of 270 days. The analytical approach to rating commercial paper and other short-term debt is the same as the one followed in assigning a bond rating. There is a strong link between short- and long-term rating systems. The correlation of short-term ratings and long-term ratings is addressed in the article titled "General Criteria: Methodology For Linking Long-Term And Short-Term Ratings," published April 7, 2017.

Bank Holding Company Commercial Paper Backup Requirements

With respect to bank holding companies (BHCs), cash flow projections and appropriate use of commercial paper proceeds are key to fundamental analysis of parent company liquidity. BHCs, by their nature, are often conduits of cash flows between investors and the underlying operating subsidiaries. Internal sources (i.e., liquid assets) most often provide the primary support for commercial paper issued by financial institutions.

In addition to commercial paper, BHCs may tap other funding sources, such as medium-term note (MTN) programs with maturities as short as seven days. To the extent that alternative funding sources are short term and highly credit sensitive, these short-term borrowings represent competing claims, along with commercial paper, for parent company resources. For this reason, BHCs need to maintain sufficient backup, in the form of liquid assets and/or bank lines, for commercial paper and its substitutes. Such substitutes would include, but would not be limited to, master note programs, sweep accounts, and other unsecured borrowings with an original maturity of less than one year.

Parent Company Liquidity

The proceeds of BHC-issued commercial paper are often downstreamed to the bank subsidiary on a matched basis. Such borrowings help to diversify the organization's funding sources and, at the same time, offer the parent company a very high degree of liquidity. When used for this purpose, commercial paper borrowings have not needed additional support from external bank lines. S&P Global Ratings recognizes that similar treatment can be applied to proceeds invested in high-quality money market instruments. For example, Treasury bills and deposit placements with unaffiliated commercial banks offer a predictable degree of safety and liquidity, provided that any maturity mismatch is within reason.

Commercial paper proceeds advanced to nonbank subsidiaries, even on a matched basis, would likely require external bank line support because the underlying operations do not have the same degree of official protection (i.e., deposit insurance) and financial flexibility (i.e., easy access to the Central Bank discount window) as a commercial bank. In addition, nonbank subsidiaries often engage in such activities as leasing, commercial finance, and consumer finance, where the underlying assets are longer term and carry a degree of credit risk. S&P Global Ratings views proceeds invested in high-yield bonds, equity securities, venture capital units, or workout subsidiaries as risky uses of commercial paper financing that would clearly require external bank-line support.

Backup Coverage

S&P Global Ratings expects that BHCs rated 'A-2' or lower maintain 100% backup coverage for all short-term, credit-sensitive borrowings (i.e., commercial paper and its substitutes) that are not downstreamed on a matched basis to bank subsidiaries. In these cases backup coverage may be in the form of highly liquid assets (i.e., CDs arbitraged in bank subsidiaries and similar high-quality money market instruments) or credit lines with unaffiliated banks. BHCs rated 'A-1' should have 50% backup coverage, while those rated 'A-1+' should have 25% backup coverage. These recommendations are guidelines and not mandatory requirements; more or less coverage may be needed as circumstances warrant. Because the quantity and quality of bank lines are integral elements of parent company liquidity, the failure to maintain a sufficient amount of coverage could have negative implications for both short- and long-term ratings.

These guidelines differ from those of industrial issuers because S&P Global Ratings recognizes the additional financing options uniquely available to BHCs. First, parent companies can borrow from affiliate banks within specified limits and collateral requirements. Second, BHCs can also transfer the assets of nonbank subsidiaries, again under certain conditions, to the bank affiliates where funding options remain more plentiful.

Tiering Of Bank Lines

S&P Global Ratings recognizes that bank lines are not alike, and the strength of such lines plays an integral part in parent company liquidity. In general, a revolving credit agreement, because it is a contractual obligation, provides more secure backup than does a committed line of credit. If relying solely on external arrangements for commercial paper support, BHCs rated 'A-2' or lower should have at least 15 days' worth of maturities (which typically translates into one-half of average commercial paper outstanding) in the form of a revolver, while those rated 'A-1' should have 10 days' worth of maturities (one-third of outstandings). The balance should be in the form of committed lines of credit. Open bank lines where no compensation is remitted (either in fees or deposit balances) or based solely on verbal agreement are not acceptable backup.

As a matter of application, the tiering requirements may be impractical for BHCs where the dollar amount of external support is small. Again, this is a function of the BHC structure, as the bulk of commercial paper support usually comes from internal sources.

In addition to the absolute amount and tiering of backup lines, S&P Global Ratings considers other qualitative factors pertaining to the banks providing such facilities. For example, a multiyear facility provided by a diversity of highly rated banks would likely prove more reliable than an annual facility from a small group of lower-rated banks. In addition, the committed amounts should not impair the capital adequacy of the bank(s) extending credit. The longevity and closeness of mutual business ties (e.g., correspondent banking relationships) between the issuing BHC and the credit-providing bank can enhance the quality of the line facility. The stronger the relationship, the more likely the line can be drawn upon, not only during periodic testing (which is certainly advisable), but also more important, during times of need.

Bank Issuance Of Commercial Paper

If a bank, as opposed to a bank holding company, issues commercial paper, no special backups are required. Banks, as the operating entity within the consolidated organization, have varying amounts of liquid assets on their balance sheets and access to a diversity of funding sources. Liquid temporary investments are the primary source of liquidity for banks and are viewed by S&P Global Ratings as more important than any off-balance-sheet funding commitment. Temporary investments include short-term deposit placements with unaffiliated banks, Fed funds sold and resale agreements, trading account assets, and government securities that mature in one year or less. Other investment securities could be considered if there is a well-established and liquid market into which they can be sold.

Banks' primary funding sources are local demand and savings deposits. Beyond these core deposits, banks may also have access to a variety of wholesale funds, such as jumbo CDs, foreign and interbank deposits, and bank notes. Furthermore, banks, depending on the regulatory regime, may have access to central bank liquidity.

Swing Lines

In certain countries, notably the U.S. and Australia, commercial paper markets require same-day settlement. In these markets, S&P Global Ratings looks for offshore bank issuers that do not have a local branch or agency to have in place a swing line or another secure source of liquidity to cover 15% of the projected maximum outstanding amount of borrowings. The 15% requirement approximates three days' worth of maturing commercial paper. Importantly, the swing lines must provide for same-day availability of funds so that the issuer can cover maturing commercial paper in the case of market disruption. The swing lines should be in the issuer's name, even if the commercial paper is guaranteed by an offshore entity. The lines should be from highly rated banks domiciled in the market where the commercial paper is issued and denominated in the local currency. Lines in a different currency may be accepted if S&P Global Ratings believes foreign exchange swaps are readily available. In some cases, a portfolio of liquid securities may be used as a substitute for the swing lines, provided that the securities are unencumbered, always available, and have a proven value in the secondary market. In some cases, the swing line requirements can be increased for banks with short-term ratings of 'A-2' or lower.

Frequently Asked Questions

1. Which entities are in scope?

Entities in scope are banks and certain non-bank financial institutions:

- Banks in scope are as defined in Paragraph 7 of the Nov. 9, 2011, "Banks: Rating Methodology And Assumptions" criteria (the "bank criteria"), i.e., "retail, commercial, and corporate and investment banks. The definition of a bank is broad and includes the larger broker-dealers, mortgage lenders, trust banks, credit unions, building societies, and custody banks. The criteria do not apply to ratings on finance companies, asset managers, exchanges, clearinghouses, and regional securities brokers."

- Since Dec. 9, 2014, nonbank financial institutions are also in scope, as per "Nonbank Financial Institutions Rating Methodology," published that day (the "NBFI criteria"), if covered by paragraphs 3 to 7 of such criteria, including certain securities firms (including retail- and wholesale-focused broker-dealers) and certain financial companies ("NBFI" in the rest of this FAQ).

2. Are only commercial paper issue credit ratings in scope?

No, for banks and NBFI in scope as per answer 1 above, all short-term issue credit ratings are in scope, including those on covered bonds.

3. Can you explain in more detail the interaction between these criteria and "General Criteria: Methodology For Linking Long-Term And Short-Term Ratings," published April 7, 2017, as you assign short-term issue and issuer credit ratings?

Our rating process typically follows three key steps.

First, we derive a bank's or NBFI's long-term ICR, chiefly by applying the bank criteria (see also "How We Rate Banks" July 8, 2013, which explains our criteria framework) or the NBFI criteria, and other relevant criteria articles such as "Group Rating Methodology", July 1, 2019.

Second, when applying the criteria on short-term/long-term linkages, we assign a short-term ICR to the issuer.

Third, we rate such an issuer's short-term obligations and programs, other than hybrid capital instruments and covered bonds, at the level of the short-term ICR (foreign- or local-currency ICR, depending on the obligation or program's currency) unless either of the two situations applies:

- They are specifically guaranteed by a higher-rated guarantor, and that guarantee meets the conditions in our criteria on credit-substitution debt guarantees (see "Guarantee Criteria," Oct. 21, 2016).
- The issuer's short-term ICR is 'D' or 'SD', in which case the short-term obligation or program may be rated higher, typically 'B' or 'C', based on its relative default risk.

Revisions And Updates

This article was originally published on March 23, 2004. These criteria became effective on March 23, 2004.

Changes introduced after original publication:

- Following our periodic review completed on Feb. 2, 2017, we updated the contact list and criteria references and added the "Related Criteria And Research," "Revision History," and "Effective Date" sections. We also noted that on Dec. 20, 2016, S&P Global Ratings issued "Request For Comments: Methodology For Linking Short-Term And Long-Term Ratings." In the scope of that article, it stated that if those criteria were issued, they would partially supersede these criteria.

- On May 5, 2017, we removed content that was superseded by the article titled "General Criteria: Methodology For Linking Long-Term And Short-Term Ratings," published on April 7, 2017, which describes the correlation of our long-term ratings with our short-term ratings, and we updated references to archived criteria articles.
- Following our periodic review completed on Jan. 31, 2018, we updated the contact information. We also added the "Revisions And Updates" section, which replaces the "Revision History" section.
- On Feb. 6, 2019, we republished this criteria article to make nonmaterial changes to the contact information.
- On Dec. 19, 2019, we republished this criteria article to delete a paragraph at the end of the answer to question 3 that should have been deleted as part of the May 5, 2017, republication of the article to remove content that had been superseded by "General Criteria: Methodology For Linking Long-Term And Short-Term Ratings," published on April 7, 2017. The paragraph was not deleted in 2017 due to an error. We also updated criteria references.
- On Feb. 4, 2021, we republished this criteria article to make nonmaterial changes. Specifically, we edited a sentence in the first paragraph of the section titled "Bank Holding Company Commercial Paper Backup Requirements" to make it clearer that internal sources are the primary support to commercial paper.

Related Criteria And Research

Related Criteria

- Group Rating Methodology, July 1, 2019
- Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Guarantee Criteria, Oct. 21, 2016
- Nonbank Financial Institutions Rating Methodology, Dec. 9, 2014
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Commercial Paper II: Finance Companies, March 22, 2004

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as S&P Global Ratings assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.